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Case No. 8657-CB

**IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE**

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| RENA A. KASTIS and JAMES E. CONROY, Derivatively on Behalf of HEMISPHERX BIOPHARMA, INC., | ) | |
| Plaintiffs, | ) | |
| v. | ) | C.A. No. 8657-CB |
| WILLIAM A. CARTER ET AL., | ) | |
| Defendants, | ) | |
| and | ) | |
| HEMISPHERX BIOPHARMA, INC., a Delaware corporation, | ) | |
| Nominal Defendant. | ) | |

# PLAINTIFFS' REPLY BRIEF IN RESPONSE TO HEMISPHERX BIOPHARMA, INC.'S RESPONSE TO PLAINTIFFS' MOTION TO INVALIDATE RETROACTIVE FEE-SHIFTING AND SURETY BYLAW OR, IN THE ALTERNATIVE, TO DISMISS AND WITHDRAW COUNSEL

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### A. *ATP* Does Not Validate Bylaw §5.07

The assertion of Hemispherx Biopharma, Inc. ("Hemispherx" or the "Company") that its new, retroactive bylaw ("§5.07" or the "Bylaw") was held valid in *ATP* is wrong.[1] First, §5.07 is fundamentally different than the *ATP* bylaw, including having a bond provision that was completely absent from the ATP bylaw. Second, the *ATP* decision provided only limited answers to theoretical certified questions concerning the "facial validity" of a fee-shifting bylaw of a non-stock corporation in the abstract. Third, the applicability of §5.07 to stockholders in this derivative litigation raises validity issues that were not raised or addressed in *ATP*.

#### 1. The Substantial Differences in the Bylaws

Hemispherx's argument that *ATP* validates the Bylaw rests on the erroneous premise that the language of the Hemispherx Bylaw closely tracks the language of the ATP bylaw.[2] The ATP bylaws were not even in the record of the Delaware Supreme Court proceedings. Indeed, the exact text of the actual fee-shifting bylaw

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[1] *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014). Hemispherx mischaracterizes §5.07 as "amended Section 5.07" and repeatedly refers to it as the "Amended Bylaw," falsely implying that it was a change to an existing bylaw. Response of Nominal Defendant Hemispherx Biopharma, Inc. to Plaintiffs' Motion to Invalidate Retroactive Fee-Shifting and Surety Bylaw or, in the Alternative, to Dismiss and Withdraw Counsel ("Response") p. 1. In fact, §5.07 is an entirely new provision not found in prior versions of the Hemispherx bylaws. *See* Hemispherx Current Report (Form 8-K) (July 10, 2014) which contains "New Section 5.07."

[2] Response ¶22(a).

does not appear in the October 3, 2013 Certification of Questions of Law by the United States District Court for the District of Delaware (the "Certification")[3] or in the *ATP* opinion. Rather, certain portions of the bylaw appear in brackets, indicating that the exact terms have been summarized or otherwise described.[4]

For example, the precise language of the ATP bylaw defining a "Claiming Party" and a "Claim" does not appear in the *ATP* opinion. The Hemispherx Bylaw contains definitions of Claiming Party and Claim that are different from the bracketed descriptions in the ATP bylaw. It also adds a definition of "Claimant" that does not appear in the ATP bylaw.[5] The differences in these definitions are important. Hemispherx interprets the definitions in the ATP bylaw as indicating the bylaw was not reciprocal, but was one-sided like the Hemispherx Bylaw. That is completely wrong. As the first certified question in ATP indicated, the theoretical bylaw considered in *ATP* was one "that applies in the event that … the corporation sues a member."[6] Thus, under the ATP bylaw the corporation could be a Claiming Party, either as the plaintiff bringing a claim against a member or as a counterclaimant in a case brought by a member. ATP specifically represented to

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[3] *See* Ex. H to Transmittal Affidavit of Paul A. Fioravanti, Jr. ("Fioravanti Aff.").

[4] *ATP*, 91 A.3d at 556.

[5] For example, §5.07(a) applies where a stockholder "initiates, asserts, maintains or continues against the Company any litigation, claim or counter-claim," while the ATP bylaw did not contain the underlined terms.

[6] *ATP*, 91 A.3d at 557.

the Delaware Supreme Court in its briefs and at oral argument that its bylaw was reciprocal and bi-lateral.[7] Thus, the *ATP* opinion did not even address the "facial validity" of a one-sided fee-shifting bylaw that unilaterally imposes financial liabilities on stockholders of a public Delaware corporation.

The imaginary bylaw addressed in *ATP* also did not contain any provision comparable to the bond requirement imposed by §5.07(b) of the Hemispherx Bylaw. Therefore, the *ATP* opinion could not have determined even the facial validity of such a provision because it did not exist in that case. Hemispherx's argument that such a bond provision is valid because other states have "statutory surety requirements"[8] actually proves the provision is invalid – Delaware has no such statutory authorization for requiring the posting of a bond.[9]

As Exhibit I to the Fioravanti Aff. illustrates, about 75% of the language of §5.07(a) and 100% of §5.07(b) differs from the contents of the ATP bylaw. The entire concept and definition of Internal Matter in §5.07(a) was absent in *ATP*.

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[7] *ATP Tour, Inc. v. Deutscher Tennis Bund,* No. 534, 2013 (Del.) Opening Brief of Appellants (Nov. 7, 2013), p. 8 (bylaw "bilaterally" applies "regardless of whether the claimant is ATP or a member"); Reply Brief of Appellants (Dec. 23, 2013), p. 9 (bylaw "creates an entirely bi-lateral rule … whether a member sues ATP or ATP sues a member"); Transcript of Argument (Feb. 19, 2014) at 53-54 (ATP's counsel represented that "there is reciprocity" and that ATP will be responsible for the member's attorneys' fees if ATP loses). Fioravanti Aff. Exs. J, K and L.

[8] Response ¶ 9.

[9] Only 9 states have such statutes, 11 states have repealed such statutes, and Delaware and other states have never adopted such statutes. Deborah A. DeMott & David F. Cavers, *Shareholder Derivative Actions: Law & Practice* §312 (2013).

Moreover, the ATP bylaw did not extend to maintaining or continuing existing "litigation." In short, the Hemispherx Bylaw is so different that the theoretical discussion in the *ATP* opinion has little, if any, relevance to the validity of §5.07.

### 2. The Limited Scope of *ATP*

*ATP* only considered abstract certified questions concerning the "facial validity" of a theoretical board-adopted bylaw providing for reciprocal fee-shifting.[10] In *ATP*, the Delaware Supreme Court described the very limited scope of a "facial validity" determination:

> To be facially valid, a bylaw must be authorized by the Delaware General Corporation Law (DGCL), consistent with the corporation's certificate of incorporation, and its enactment must not be otherwise prohibited. That, under some circumstances, a bylaw might conflict with a statute, or operate unlawfully, is not a ground for finding it facially invalid.[11]

Thus, a bylaw can be "facially valid" even if, as here, there are circumstances where the bylaw conflicts with a statute, certificate provision or common law rule. Similarly, *Boilermakers*[12] held that a board-adopted bylaw is facially invalid only if the stockholder shows it "cannot operate validly in any conceivable

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[10] *ATP*, 91 A.3d at 557-559 (repeatedly referring to "facially valid").

[11] *Id.* at 557-58 (footnotes omitted).

[12] *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934, 938, 943, 944 & n.41, 44, 945, 946, 947 & n.62 (Del. Ch. 2013) (repeatedly referring to determining "facial validity").

circumstance."[13] Even on defendants' motion for judgment on the pleadings, *Boilermakers* put the burden on the stockholders to establish facial invalidity:

> [Plaintiffs] must show that the bylaws cannot operate lawfully or equitably *under any circumstances*. So the plaintiffs must show that the bylaws do not address proper subject matters of bylaws as defined by the DGCL in 8 *Del. C.* § 109(b) and can never operate consistently with law.[14]

*ATP*'s discussion of the "facial validity" of a fee-shifting bylaw was not only hypothetical, but also was a very limited and specialized consideration of the "validity" of such a theoretical bylaw. Because *ATP* involved certified questions of law, the Court could not "directly address the bylaw at issue."[15] The Court only held that "fee-shifting provisions in a non-stock corporation's bylaws can be valid

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[13] *Boilermakers*, 73 A.3d at 940; *see also id.* at 941 (stockholder must show "the bylaws are invalid in all circumstances").

[14] *Id.* at 948-49. The Chancellor acknowledged that this nearly impossible facial validity standard for stockholders challenging board-adopted bylaws is very different from the opposite standard the Delaware Supreme Court adopted for stockholder-adopted bylaws in *CA, Inc. v. AFSCME Empls. Pension Plan*, 953 A.2d 227 (Del. 2008), where the bylaw was held invalid because there was some circumstance where the bylaw could conflict with 8 *Del. C.* § 141(a). *Boilermakers*, 73 A.3d at 949 n.62. The Court attempted to reconcile the divergent standards by observing that *CA* involved certified questions. However, *ATP* involved certified questions, but applied the *Boilermakers*' standard.

[15] *ATP*, 91 A.3d at 555.

and enforceable under Delaware law," but did not hold any particular provisions were valid or enforceable.[16]

Under 8 *Del. C.* § 111(a)(1), this Court is authorized to "interpret, apply, enforce or determine the validity of the provisions of" the bylaws. As *ATP* recognized,[17] the determination of validity includes considering whether the Bylaw conflicts with a statute or operates unlawfully under the circumstances of this existing derivative case. As shown below, there are such conflicts under the circumstances involved here. Moreover, in *ATP* no issue was raised, much less decided, whether under 8 *Del. C.* § 102(b)(6) provisions imposing personal liability on stockholders must be contained in the certificate of incorporation, not the bylaws. Thus, *ATP* cannot foreclose consideration of the validity of the very different Hemispherx Bylaw under the very different circumstances and procedural posture of this case. *ATP* certainly cannot preclude this Court from its statutorily assigned tasks of determining the interpretation, application and enforceability of the Bylaw under the particular situation involved here.

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[16] *Id.* Contrary to Hemispherx's superficial comments, there are significant differences between publicly traded stock and private non-stock corporations, such as ATP. Fundamental provisions of the DGCL relating to stock ownership, business combinations, meetings and voting, mergers and dissolutions do not apply to non-stock corporations. 8 *Del. C.* § 114(b)(2).

[17] 91 A.3d at 558.

The nature of the Hemispherx Bylaw, which imposes financial liability on stockholders, makes prompt judicial consideration particularly important. *Boilermakers* upheld the "facial validity" of forum bylaws that "regulate where stockholders can exercise their right to bring certain internal affairs claims against the corporation and its directors and officers." 73 A.2d at 951. The Court said such bylaws are "process-oriented, because they regulate *where* the stockholder may file suit, not *whether* the stockholder may file suit or the kind of remedy that the stockholder may obtain on behalf of herself or the corporation." *Id.* at 951-52. As the Chancellor further explained:

> In other words, the forum selection bylaws only regulate *where* a certain set of claims, … may be brought, not *what* claims.[18]

In contrast, the Hemispherx Bylaw does not just regulate where claims may be brought, but creates new claims against stockholders for substantial financial liability. The Bylaw will affect whether a stockholder will file or maintain a suit because it establishes a financial liability that makes it economically irrational for Plaintiffs, or any other stockholders, to pursue derivative claims. Hemispherx's September 6, 2013 Proxy Statement reveals that no stockholder owns 5% or more of the Company's outstanding stock. This demonstrates two things: every stockholder will be subject to the bond requirement of §5.07(b), and no

[18] *Id.* at 960 (emphasis added).

stockholder will have a large enough financial interest for it to make financial sense to take on the risk of a large liability for fees and expenses.[19]

### B. The Bylaw Conflicts with the Common Law Right of Stockholders to Bring Derivative Suits

#### 1. *ATP* Was Not a Derivative Suit

*ATP* involved individual direct claims by owners of tour events who claimed the challenged corporate action by a non-public, non-stock Delaware corporation had caused them $80 million in damages, plus treble damages under federal antitrust laws.[20] It was not a stockholder derivative case. Consequently, the *ATP* opinion did not consider whether the theoretical bylaw that was the subject of the certified questions would run afoul of the statutes, rules and common law that govern derivative actions.[21]

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[19] According to *Yahoo! Finance*, The Vanguard Group, Inc. and BlackRock Institutional Trust Company, N.A. are the largest Hemispherx stockholders, each owning about 4.5 million shares (about 2.45% of the outstanding shares), which at the $0.30 market price cited in paragraph 12 of the Hemispherx Response are worth about $1,350,000—an investment that would not justify the risk of liability under §5.07 that might exceed that value. Fioravanti Aff. Ex. M.

[20] Certification, p. 6.

[21] The enforcement of the ATP bylaw was pursuant to Fed. R. Civ. P. 54(d)(2), which authorizes motions asserting claims for attorneys' fees. Court of Chancery Rule 54(d) contains no comparable provision.

### 2. A Derivative Suit Is a Judicial Creation That Is to Be Regulated by the Courts, Not the Board of Directors

The judicial origins of the derivative suit were acknowledged in *Harff v. Kerkorian*, 324 A.2d 215, 218 (Del. Ch. 1974), *modified*, 347 A.2d 133 (Del. 1975):

> The derivative action was developed by equity to enable stockholders to sue in the corporation's name where those in control of the corporation refused to assert a claim belonging to the corporation.

More recently, the Delaware Supreme Court reiterated that the courts are to control derivative actions, stating in *CML V, LLC v. Bax*, 28 A.3d 1037, 1044 (Del. 2011):

> At common law, courts of equity granted equitable derivative standing to corporate stockholders to sue on behalf of a corporation in order to prevent failures of justice. This Court has recognized that a corporate derivative action is a "judicially-created doctrine" and a "creature of equity" that serves as a "vehicle to enforce a corporate right."

The right of stockholders to bring a derivative action actually pre-dates the Delaware General Corporation Law. *Id*.

The equitable right of a stockholder to bring an action derivatively on the corporation's behalf is grounded upon the interests of justice.[22] The derivative right is a necessary means for invoking judicial power to curb managerial abuse

[22] *Schoon v. Smith*, 953 A.2d 196, 201 (Del. 2008).

and thereby provide stockholders with an effective voice in the administration of the corporation.[23]

Shareholders have the right to maintain a derivative action, even though that right impinges on the directors' statutory power under 8 *Del. C.* § 141(a) to manage the corporation.[24] The power to regulate the judicially created derivative action rests with the judiciary.[25] The General Assembly also has the power to regulate derivative suits, though 8 *Del. C.* § 327 is the only statutory restriction it has imposed.[26] The law imposes restrictions on the stockholders' judicially created equitable right to maintain a derivative action by court rule, by statute or by judicial decision.[27] While the courts and the General Assembly are empowered to regulate derivative actions, the directors who are defendants in such actions are not.

Delaware has a public policy interest in ensuring that its courts are available to derivative plaintiffs who seek to hold directors and officers accountable to the

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[23] *Id.*

[24] *Ark. Teacher Ret. Sys. v. Countrywide Fin. Corp.*, 75 A.3d 888, 897 & n.37 (Del. 2013).

[25] *Schoon*, 953 A.2d at 204-05.

[26] *Id.* at 203-04; *CML V, LLC v. Bax,* 6 A.3d 238, 242 (Del. Ch. 2010), *aff'd,* 28 A.3d 1037 (Del. 2011).

[27] *See, e.g.*, Court of Chancery Rule 23.1's demand requirement; the continuous ownership requirement of 8 *Del. C.* § 327; the special litigation committee procedure of *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

corporation.[28] The public policy includes ensuring that corporate conduct does not go unchallenged because it would be prohibitively costly or impracticable for a stockholder to pursue a derivative suit.[29] Therefore, Delaware's public policy is to provide a cost-sharing incentive for bringing a derivative action because otherwise the costs to the plaintiff will be too great in comparison to her small pro rata interest in any recovery.[30] The Hemispherx Bylaw conflicts with Delaware's public policy because it is a board-created disincentive which makes the pursuit of derivative actions prohibitively risky financially in light of the individual stockholder's limited interest in any recovery or other remedy.

The Hemispherx Bylaw also conflicts with Delaware common law regarding the dismissal of a demand excused derivative action. Where, as in this case, demand is excused,[31] the Delaware Supreme Court in *Zapata* established specific

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[28] *Sample v. Morgan*, 935 A.2d 1046, 1065 (Del. Ch. 2007). Delaware's public policy is expressed not only through legislation but also through the common law. *Nationwide Gen. Ins. Co. v. Seeman*, 702 A.2d 915, 917 (Del. 1997).

[29] *Julian v. E. States Constr. Serv. Inc.*, 2009 WL 154432, at *2 (Del. Ch.); *Carlson v. Hallinan*, 925 A.2d 506, 547-48 (Del. Ch. 2006); *Fisher v. Council of The Devon*, 1999 WL 1313661, at *2 (Del. Ch.); Donald J. Wolfe, Jr. & Michael A. Pittenger, *Corporate and Commercial Practice in the Delaware Court of Chancery*, §9-5(a) at 9-232 (2014).

[30] *Julian*, 2009 WL 154432, at *2; *Fisher*, 1999 WL 1313661, at *2; *Bird v. Lida, Inc.*, 681 A.2d 399, 403 (Del. Ch. 1996).

[31] Hemispherx's factual recitation ignores that—well after defendants failed to respond to the Complaint within the time required under the Court of Chancery Rules—its counsel called Plaintiffs' counsel and stated that defendants intended to file a motion to dismiss for failure to plead demand futility. During that call,

procedural steps and legal standards for dismissal of a derivative action when a special litigation committee has been employed.[32] The *Zapata* procedure controls when and how a committee of the board is permitted to cause dismissal of a properly initiated derivative action, based on the directors' determination that the litigation is not in the best interests of the corporation.[33] *Zapata* recognized that if the board can wrest derivative actions from well-meaning derivative plaintiffs, "the derivative suit will lose much, if not all, of its generally-recognized effectiveness as an intra-corporate means of policing boards of directors."[34] The *Zapata* procedure provides "a balancing point where *bona fide* stockholder power to bring corporate causes of action cannot be unfairly trampled on by the board of directors."[35] *Zapata* requires that an independent committee conduct a thorough and objective investigation and determine whether derivative litigation is in the corporation's best interest. If the committee seeks dismissal, the court must inquire into the independence and good faith of the committee and the bases for its

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Plaintiffs' counsel informed Hemispherx's counsel that demand was excused because two of the four directors were recipients of the challenged bonuses. It was only after that call that Hemispherx went back to the well to recruit defendant Carter's long-time friend, former Hemispherx director and current consultant, Peter Rodino III to return to the board and lead an SLC designed to derail the complaint. *See* Letter to Court dated July 26, 2013 attached as Ex. N to the Fioravanti Aff.

[32] 430 A.2d at 786-89.

[33] *Id.* at 785.

[34] *Id.* at 786.

[35] *Id.* at 787 (emphasis added).

conclusions, and then the court must apply its own independent judgment as to whether the derivative action should be dismissed.[36]

Hemispherx acknowledges that its board created a special litigation committee, which conducted an investigation and filed a motion to dismiss, and that discovery into the SLC process is ongoing.[37] However, while the review of the SLC process was occurring, the full board, including the recipients of the bonuses, not the SLC, took action to unfairly trample on this derivative suit by changing the rules to threaten Plaintiffs with ruinous liability and a bond requirement if they continue or maintain this action. The Hemispherx Bylaw requires Plaintiffs to risk substantial liability in order to examine and challenge the SLC process and report. Consequently, the Bylaw conflicts with the procedure the Delaware Supreme Court said should be followed for dismissal of a demand excused case when directors believe the suit is not in the company's best interest.

### C. The Bylaw Violates 8 *Del. C.* § 102(b)(6)

8 *Del. C.* § 102(b)(6) requires that provisions imposing personal liability for corporate debts on stockholders to a specified extent and upon specified conditions must be contained in the certificate of incorporation.[38] Delaware law respects the

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[36] *Id.* at 788-89.

[37] Response ¶¶7, 9-11.

[38] 1 David A. Drexler et al., *Delaware Corporation Law and Practice*, §6.02[6], at 6-17 (2011). The exception for liability "by reason of their own conduct and acts" is limited to personal conduct outside their traditional role as stockholders which is

principle of limited liability so that stockholders generally are able "to limit their risk to the amount of their investment in the entity."[39] Limited liability is necessary because stockholders are passive investors.[40] Piercing the corporate veil to hold a stockholder personally liable for debts or liabilities of the corporation is "in derogation of the fundamental premise of limited entity liability."[41]

The Bylaw violates the limited liability of Plaintiffs and the other stockholders of Hemispherx. Stockholders have an equitable right as stockholders to bring claims for breach of fiduciary duty, including as derivative and class claims. Indeed, 8 *Del. C.* § 327 requires stockholder status as a condition to maintaining a derivative action. Thus, stockholder litigation is a traditional role for stockholders. The Bylaw imposes personal liability on stockholders for exercising their equitable right as stockholders to challenge corporate conduct. Therefore, the

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actionable. *Id.*; s*ee also Fields v. Synthetic Ropes, Inc.*, 215 A.2d 427, 433 (Del. 1965) ("A stockholder of a corporation is not personally liable for the corporate debts…"); *Dellaversano v. Estate of DiSabatino*, 1998 WL 960702, at *5 (Del. Ch.) (Under § 102(b)(6) stockholders are generally not personally liable for debts and obligations of the corporation); *Chevron Corp. v. Salazar*, 807 F. Supp. 2d 189, 195-96 (S.D.N.Y. 2011) ("It is a bedrock principle of corporate law that shareholders – even sole shareholders – of a corporation ordinarily are not liable for the corporation's debts or obligations …").

[39] *Feeley v. NHAOCG, LLC*, 62 A.3d 649, 667 (Del. Ch. 2012).

[40] *Bird*, 681 A.2d at 402.

[41] *State v. Preferred Florist Network, Inc.*, 791 A.2d 8, 21 (Del. Ch. 2001).

Bylaw violates § 102(b)(6) and the fundamental principle of Delaware corporate law that stockholders have limited liability.[42]

### D. A Larger Factual Record Is Not Required

#### 1. There Is No Need for, and Plaintiffs Cannot Risk, Discovery and an Evidentiary Hearing

Defendants have a strange way of carrying out their supposed purpose of deterring expensive litigation.[43] They claim that determining the validity and enforceability of the Bylaw will "require the parties to engage in discovery about the timing, language, context, purposes and effects of the Amended Bylaw."[44] They insist "the parties must engage in discovery" and then there must be an evidentiary hearing.[45] Indeed, "Hemispherx has no objection to the launching of such discovery."[46] In short, Defendants' approach to deterring expensive litigation is to require more expensive litigation.

Defendants do not need discovery. They are in possession of all information "about the timing, language, context, purposes and effects of the Amended Bylaw." Plaintiffs cannot engage in discovery, whether about the SLC or the

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[42] *See* 13 William Meade Fletcher et al., *Fletcher Cyclopedia of the Law of Private Corporations* § 6218 (2013) ("[I]n the absence of charter or statutory authority, a corporation cannot make a valid bylaw imposing upon shareholders personal liability for its debts").

[43] Response ¶33.

[44] *Id.* ¶32.

[45] *Id.* ¶34.

[46] *Id.*

Bylaw, because then they will incur potential liability for continuing and maintaining this litigation, even if they prevail on some of their claims. The Bylaw is so broad that even challenging the Bylaw carries the risk of crushing liability. Hemispherx cannot complain about "its right to a hearing" when Defendants have deliberately changed the rules during existing derivative litigation to make it prohibitively risky for Plaintiffs to assert their right to a hearing.

**2. There Is a Sufficient Record**

The assertion that Plaintiffs' motion is limited to the facial validity of the Bylaw because there is no record before the Court[47] is incorrect both factually and legally. Legally, Plaintiffs are entitled to seek a determination of the validity, not just facial validity, of the Hemispherx Bylaw under the circumstances of this stockholder derivative case, as well as its interpretation, application and enforceability.

Factually, there is a sufficient record. Plaintiffs' motion provided the Bylaw, related 8-K and a number of other exhibits, including the letter from Hemispherx's counsel invoking the Bylaw against the Plaintiffs in this action. The Complaint and other filings in this case establish the derivative nature of this case, the claims asserted and the other circumstances involved in this litigation. Other facts, such as Plaintiffs' limited financial stake, have been cited in the Hemispherx

[47] Response ¶16.

Response. Particularly given the plain language of the Bylaw, there can be no dispute that the Bylaw was not adopted "on a clear day," but was directed at this existing derivative litigation. Any doubt on that score was eliminated by the July 18, 2014 letter of Hemispherx's counsel notifying Plaintiffs of the Bylaw and warning them that if they "continue to pursue their claims in this action," they "shall be obligated" under §5.07 and *ATP* to pay Defendants' fees and expenses if their claims do not fully succeed. The SLC's counsel confirmed that Hemispherx intends to use the Bylaw "as a sword" against cases like this one that the Company claims are without merit.[48]

### E. Plaintiffs' Bylaw Claim Is Ripe

For Plaintiffs, challenging the Hemispherx Bylaw is now or never. Waiting until later to attack this draconian Bylaw is not an option because the Bylaw itself creates a huge and unacceptable financial risk if Plaintiffs continue with this litigation. Defendants changed the rules in the midst of this litigation, but now claim Plaintiffs cannot challenge those newly minted rules until the end of the case. For Plaintiffs, now is the end of the case because they must dismiss if the Bylaw stands. Claiming the Court might serve as a "gatekeeper" at later points

[48] *Id.* Liz Hoffman, *Shareholder Suit Involving Loser-Pays Provision Heats Up in Delaware*, Wall St. J., July 22, 2014. Fioravanti Aff. Ex. O.

"[i]f the litigation went forward to conclusion"[49] is meaningless because the Bylaw forces Plaintiffs to exit the gate now.

### 1. The Deterrent Effect of the Bylaw Is the Current Threat of Liability

Hemispherx admits that the purpose of the Bylaw is "to deter expensive and unjustified litigation."[50] However, it then insists that determining the validity, interpretation, application and enforceability of the Bylaw should only occur after the underlying derivative litigation is over.[51] At that point, the expensive litigation would have already occurred and could not be deterred. As the language of the Bylaw demonstrates, the conduct that the Bylaw seeks to deter is the initiation, assertion, maintenance or continuation of any litigation, claim or counter-claim. Deterrence of that conduct is based on the current threat of potential liability, not end of the case proceedings. That is particularly clear in this action because Defendants crafted the Bylaw specifically so Plaintiffs will become subject to the liability threat if they continue or maintain pre-existing litigation. Thus, Defendants structured the Bylaw so that Plaintiffs must choose now to discontinue the litigation now or incur the risk that they may lose hundreds of thousands if not millions of dollars. Hemispherx's attempt to delay judicial consideration of the

[49] Response ¶37.
[50] *Id.* ¶33.
[51] *Id.* ¶¶33, 36.

validity and enforceability of the Bylaw only confirms that the provision's purpose is to create uncertainty and risk that will result in dismissal of this litigation.

### 2. The Bylaw Applies to this Litigation

Hemispherx's assertion that it has not sought to apply the Bylaw to Plaintiffs in this litigation is false.[52] The Bylaw was deliberately drafted to apply to this existing derivative case and expressly states that it applies if Plaintiffs continue or maintain the litigation. Hemispherx admits it sent to Plaintiffs' counsel a notification of the applicability of the Bylaw to this litigation.[53] That letter specifically stated that the Bylaw applies to this litigation and threatens Plaintiffs with liability under the Bylaw if they "continue to pursue their claims in this action."

Hemispherx also has reconfirmed that "Hemispherx and its directors do not believe that the claims have merit."[54] Indeed, it has produced an SLC report and filed a motion to dismiss detailing its directors' view that the litigation is without merit.

Hemispherx's Response also establishes the large financial risk the Bylaw creates for Plaintiffs. It confirms that this litigation has caused the Company "to

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[52] *Id.* ¶¶4, 36.
[53] *Id.* ¶14.
[54] *Id.* ¶¶6, 38.

incur substantial expense" that already is "hundreds of thousands of dollars."[55] The Response references that Hemispherx is responsible for the fees of the SLC and that further fees will be incurred if discovery of the SLC members and briefing of the SLC's motion to dismiss proceeds.[56] Hemispherx acknowledges that, given the minimal trading price of its stock, Plaintiffs' 1,460 shares are currently worth approximately $438, but that Plaintiffs may be required to post a bond to cover the estimated amount of Defendants' legal expenses, even though Plaintiffs "do not have a large stake in the company."[57] Even proponents of fee-shifting bylaws admit such provisions will chill litigation by individual shareholders.[58] As the Third Circuit noted, a bylaw imposing fees on a plaintiff who does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought "is not your average fee-shifting provision."[59]

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[55] *Id*. ¶¶6, 12.

[56] *Id*. ¶¶9, 11.

[57] *Id*. ¶¶12-13.

[58] William J. Sushon et al., *Shifting Sands: Practical Advice on Delaware Fee-Shifting Bylaws*, N.Y.L.J. (Aug. 11, 2014), p. 3. Fioravanti Aff. Ex. P. The notion that large institutional investors will not be intimidated by fee-shifting bylaws (*id*.) ignores that while the overall stock ownership of such institutions may be large, their ownership in any particular company is usually small.

[59] *Deutscher Tennis Bund v. ATP Tour, Inc.*, 480 Fed. Appx. 124, 128 & n.4 (3d Cir. 2012).

The Bylaw also forces Plaintiffs to dismiss because it essentially means Plaintiffs would have to litigate two cases: the underlying bonus claims and claims regarding the Bylaw. In essence, the Bylaw doubles Plaintiffs' effort and risk.

If the Court refuses to allow Plaintiffs to challenge the new liabilities Defendants have imposed through this Bylaw, Plaintiffs will also have to dismiss or face the risk that Defendants may decide to change the rules for this litigation again. Indeed, Hemispherx's counsel is already engaging in modifying the rules further, claiming that, despite the plain language of the Bylaw, they will not interpret the Bylaw to include Plaintiffs' counsel and will not pursue recovery of fees and expenses against them.[60] Similarly, the defense lawyers now say it was not Hemispherx's intent for the Bylaw to apply retroactively—but that is what the plain terms of the Bylaw say.[61] The ability of Hemispherx and its directors and lawyers to rewrite the rules further if Plaintiffs continue this litigation is yet another reason that either the Court must invalidate such self-interested rule changes now or Plaintiffs must dismiss.

### 3. The Bylaw Challenge Is Ripe

In *Stroud v. Grace*, 606 A.2d 75, 95 (Del. 1992), the Court held that the provision of the corporation's nomination bylaw that allowed for disqualification

[60] Response ¶30.

[61] *Id.* ¶37 n.2. There is no indication that Hemispherx held a Board meeting and the Board adopted either of these positions.

of nominees at the annual meeting did not apply because plaintiffs' nominees had not been disqualified, but had been nominated at the annual meeting and rejected by the stockholders. *Boilermakers* recognized that a challenge to an exclusive forum bylaw would be ripe on a motion to dismiss at the outset of a case filed in a jurisdiction other than Delaware.[62] In this case, Hemispherx is contending that Plaintiffs can only challenge the Bylaw by litigating the entire case and assuming liability for a six or seven figure amount of fees and expenses. Of course, even a small risk of such a devastating liability makes it financially irrational for Plaintiffs to proceed, so the reality is the Bylaw can never be challenged if the Court decides such a challenge can only come after the underlying case has been decided. Moreover, given the Bylaw's requirement that Plaintiffs can only avoid liability by essentially achieving complete success on all claims, the risk of liability is extremely high.

### F. The Bylaw Is Unenforceable on Equitable Grounds

Bylaws must be reasonable.[63] The Hemispherx Bylaw is anything but reasonable. It is retroactive and one-sided. It imposes a liability standard that few stockholders (and few litigants of any kind) will ever meet. Even a favorable settlement that recovered fifty percent of the bonuses would not eliminate the

[62] 73 A.3d at 938, 954, 958.

[63] *Frantz Mfg Co. v. EAC Indus.*, 501 A.2d 401, 407 (Del. 1985); *Allen v. Prime Computer, Inc.*, 540 A.2d 417, 420-21 (Del. 1988).

stockholders' liability under the Bylaw because there would be no judgment on the merits, and the litigation would not have substantially achieved, in substance and amount, the full remedy sought. As discussed above, the Hemispherx Bylaw imposes liability upon stockholders beyond the value of their stock and conflicts with their equitable right to pursue a derivative suit.

In *Schnell v. Chris-Craft Indus., Inc.*,[64] the Delaware Supreme Court held that a board-adopted bylaw amendment to schedule the annual stockholders meeting 34 days earlier was unenforceable. The Court of Chancery found that the bylaw had "the purpose of cutting down on the time which would have otherwise been available to plaintiffs and others for the waging of a proxy battle." *Id.* Specifically, the amendment reduced the time for a proxy contest from 87 days to 53 days. *Id.* at 438-39.

The Delaware Supreme Court held that the 34 day reduction in the time for waging a proxy contest established that the directors had manipulated the corporate machinery "for the purpose of obstructing the legitimate efforts of dissident stockholders in the exercise of their rights." *Id.* The Court said that the directors may not amend the bylaws "in order to obtain an inequitable advantage in the contest." *Id.*

[64] 285 A.2d 437, 439 (Del. 1971).

The Hemispherx Bylaw has far greater effects than a 34 day reduction in the time for waging a proxy contest. It imposes financial liability that renders it economically irrational for Plaintiffs to continue this derivative litigation. The directors have obstructed Plaintiffs' legitimate efforts to challenge the corporate bonuses through a derivative case, including disputing the legitimacy of the SLC proceedings as contemplated by *Zapata*. The Board amended the bylaws in order to obtain an inequitable advantage in the context of this existing derivative litigation by imposing non-reciprocal, retroactive fee-sheeting based on a success standard that is virtually impossible for Plaintiffs to meet. The Bylaw is invalid because its admitted purpose is to deter this litigation from proceeding and to force termination of this existing derivative action with no exercise of independent judgment by this Court that termination of this litigation was in the best interest of the corporation.[65]

[65] *Merritt v. Colonial Foods, Inc.*, 505 A.2d 757, 764-65 (Del. Ch. 1986).

## CONCLUSION

Because the Bylaw will force dismissal of this action and raises important Delaware law issues, the Court should establish a briefing schedule and set a hearing date to determine the validity, interpretation, application and enforceability of the Bylaw under the circumstances of this stockholder derivative case.

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## CERTIFICATE OF SERVICE

I, Michael Hanrahan, do hereby certify that on this 13th day of August 2014, I caused a copy of the foregoing **Plaintiffs' Reply Brief in Response to Hemispherx Biopharma, Inc.'s Response to Plaintiffs' Motion to Invalidate Retroactive Fee-Shifting and Surety Bylaw or, in the Alternative, to Dismiss and Withdraw Counsel** be filed and served via LexisNexis File upon the following counsel of record:

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